Review of Regulatory Tax Approach

Supplementary Response

4 December 2018

Energy Networks Australia

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Background

This supplementary submission provides Energy Network Australia's response to a number of claims made in a recently published submission to the Australian Energy Regulator's Review of Regulatory Tax Approach by the Commonwealth Department of Energy and the Environment.

Response

Claim #1 - +Differences between regulatory tax allowances and tax paid is evidence that "the model is clearly enriching networks at the cost to consumers"[1]

Response

In ENA's view this statement appears to fail to fully consider the detailed analysis of the drivers of the difference discussed by the AER's expert tax advisory firm, PWC.

As that analysis shows, a large part of the difference is due to payments that have been made by Network Service Providers (NSPs) entirely outside of the regulatory model and allowances. These include costs such as research and development activity, and stamp duty arising from recent sales transactions.

ENA understands that further information around these costs and drivers is being provided beyond the initial information voluntarily provided by networks.

It is important to note that these are payments that have been funded entirely by investors and consumers have not contributed to them at all. Allowing NSPs to claim a tax deduction in relation to payments that they alone have made cannot objectively be said to be enriching networks at the cost of consumers.

Claim #2 - A pass-through approach has not been tested[2]

Response

ENA is unclear about the basis of this statement. The potential costs and benefits of a tax pass-through approach have been a direct focus of stakeholder consultation and discussions since the commencement of the AER's review in May of this year. The option has been considered in further detail across a range of expert reports and multiple submissions since June.

The costs and benefits of a pass-through approach were also widely discussed and tested at a series of AER workshops, forums and associated stakeholder discussions at which representatives of the Department, ATO, AER, consumers, tax advisors and networks were present.

The pass-through approach has been broadly rejected by the AER's expert advisers, other expert advisers, and a wider range of stakeholders for the sound reasons detailed across a number of AER and expert reports.

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[1] Mr Rob Heferen, Letter to Mr Warwick Anderson, 23 November 2018, p.1
[2] Mr Rob Heferen, Letter to Mr Warwick Anderson, 23 November 2018, p.1 and Department of Energy and Environment Submission, 23 November 2018, p.4

In this regard we note that the Consumer Challenge Panel – a key consumer body which originally raised this matter in individual network determinations - has stated in its recent submission in response to the AER Discussion Paper that it agrees with the AER's decision to not move to a pass-through approach, subject to progress towards a benchmark that better reflects the tax position of the benchmark entities.[3]

Claim #3 - No taxation allowance should be provided where company structure is not present[4]

Response

The claim that no taxation allowance should be provided where assets are held outside a company structure is inconsistent with a regulatory revenue setting approach which provides for the recovery of efficient costs across the regulated Australian infrastructure sector.

Regardless of the form of structure used (company, trust, and partnerships), taxation liabilities from profits from operation will arise either at a company level, or in the hands of beneficiaries or end investors.

Failure of the energy regulatory framework to provide any recovery of these efficient costs would result in:

- Failure of efficient cost recovery condition: Violation of the 'Net Present Value=0' principle upon which the Australian Energy Regulator bases revenue and pricing decisions impacting on over $100 billion of energy network infrastructure, and which is the common underpinning of infrastructure regulation across Australia.[5] Under an approach which provided no taxation allowance unless a company structure was present any network that was structured so that tax was paid directly by investors or via tax-equivalence payments would be an NPV<0 entity.
- Regulatory incentives to change structures without any clear benefit to the long-term interests of energy consumers: Arising from businesses having an incentive to incorporate and incur company tax in order to receive an offsetting reduced tax liability.
- Introduction of a systematic investment bias away from regulated network infrastructure compared to every other regulated infrastructure sector in Australia: This approach has not been considered or applied in any other sector

[3] AER Consumer Challenge Panel Subpanel 22 Submission, 25 November 2018, p.5
[4] Mr Rob Heferen, Letter to Mr Warwick Anderson, 23 November 2018, p.1
[5] See AER *Rate of Return Guideline – Draft Guideline Explanatory Statement*, July 2018, p.72, which states *"The NPV=0 condition means that the ex-ante expectation is that over the life of an investment the expected cash flow from the investment meets all the operating expenditure and corporate taxes, repays the capital invested and there is just enough cash flow left over to cover investors' required return on the capital invested"*

ENA observes that no other stakeholder to date has supported an approach which would result in a particular ownership structuring decision leading to no taxation allowance being received.

Claim #4 – Benefit of tax deductions from additional costs incurred outside of regulatory allowances should be used to reduce regulatory allowances[6]

Response

Elements of the Department's submission appear to suggest that the entire benefit of tax deductions associated with costs that are not recovered in regulated revenue allowances should be transferred to energy consumers.

That is, it appears to be suggested that where a network business incurs at its discretion additional costs entirely at equity owners risks (such as higher than benchmark gearing, or research and development activities), the taxation benefits of these activities – which consumers make no contribution towards through regulated prices – will be passed through to consumers of regulated network services.

Such an approach is inappropriate for the same reasons that underpin the AER not providing network businesses with higher allowances merely on evidence that its actual costs are higher than the level of a benchmark efficient provider.

Introducing the approach proposed would represent a fundamental movement away from the benchmark-based approach that applies across Australian infrastructure regulation.

Claim #5 – Adoption of a company benchmark is inappropriate because only 7 of 17 NSPs are taxed as an Australian company[7]

Response

This claim does not take into account the more relevant metric of the proportion of tax asset base that is subject to the company tax rate. AER's advisor PWC reports:

> *"In our opinion, given the majority of NSPs are held via companies, the assumption that the benchmark efficient entity is a company and taxed at the corporate tax rate is reasonable. Relevantly:*
>
> *• 72.3% of regulated asset owners (by TAB value) currently adopt a structure which is subject to the corporate tax rate. This is indicative that the benchmark efficient entity should remain a company for the purpose of determining the regulatory tax allowance."*[8]

Elsewhere, PWC note that 66% of the TAB value of Australian networks are held by NSPs taxed as companies.[9]

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[6] Department of Energy and Environment Submission, 23 November 2018, p.5-6
[7] Department of Energy and Environment Submission, 23 November 2018, p.4
[8] PWC *AER Tax Review 2018 - Expert Advice*, 26 October 2018, p.18
[9] See PWC *AER Tax Review 2018 - Expert Advice*, 26 October 2018, p.50

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The conclusion formed therefore appears to be contrary to expert tax audit firm advice on its face, and adopt a metric (entity number) which has no direct relevance to the proportion of assets held by the assumed benchmark structure.

As an example, if 90% of the tax asset value of network assets in a regulatory jurisdiction are held by a single firm in a company entity, with the remainder held by 99 small individual trusts, it would clearly not accurately reflect the underlying economic realities to declare that on a 'weight of numbers' basis the benchmark should be a trust structure.

Claim #6 – Consumer would have benefitted if a cost-pass through approach had been adopted in the past[10]

Response

The Department's submission appears to suggest that a relevant consideration for the AER in its review is that had a cost-pass through approach been applied to historical tax payments, cost savings would have been passed through to consumers.

This suggestion does not reflect a critical relevant point. That is that if a cost-pass through approach had been implemented in the manner suggested, each network company would have faced clear and immediate economic incentives to restructure as companies. This in turn would have resulted in the claimed 'cost-savings' not having actually arisen. There may have been other steps networks would have taken to respond to a cost pass-through approach. It is impossible to meaningfully identify what would have occurred in the past in a hypothetical scenario.

This also demonstrates the complexities of assessing the actual impacts of implementing changes without a careful consideration of both first-round and second-round impacts on firm or individual actions. ENA considers best practice regulatory policy assessments and recommendations need to take into account such foreseeable incentives. Clearly, consideration of a past hypothetical 'benefit' that would likely never have arisen in practice is irrelevant to considerations of the costs and benefits of future regulatory action.

Claim #7 – Cost savings can only arise through movement to an actual tax pass through approach

Response

The Department states that it 'does not understand' how the efficient tax practices of a particular entity are passed onto consumer in subsequent reviews, and suggests that the ruling out of a pass through approach may prevent this.[11]

Adoption of an updated set of benchmark assumptions across a range of review issues will result in consumer charges reflecting the new benchmark efficient approach. The mechanism by which this principally occurs is through changes in the assumptions and inputs to the AER's Post Tax Revenue Model.

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[10] Department of Energy and Environment Submission, 23 November 2018, p.4-5
[11] Department of Energy and Environment Submission, 23 November 2018, p.5

An example of this is any AER determined change to move to a diminishing value, rather than straight-line depreciation approach across a range of network assets.

A changed assumption of what represents the efficient benchmark practice in this regard will flow through to the calculations of the level of corporate income tax required at each network revenue determination.

This is conceptually exactly the same as the AER changing its view about the benchmark efficient level of any other part of the building-block revenue component (such as operating or capital costs).

Claim #8 – Upstream tax records are easily attainable through publically available financial records[12]

Response

ENA is advised that it is incorrect to assume information relating to upstream investors can be easily obtained through publically available financial reports.

At the upstream level, investments in the network may be consolidated with other investments.

This appears to be supported by the submission itself noting that none of the upstream investors approached by AER provided data in response to the voluntary information request.

Claim #9 – Consumers would be 'no worse off' were NSPs to restructure and increase their current tax payments in response to a tax pass-through system being adopted, more government revenue represents a welfare benefit[13]

The submission appears to indicate that the AER should take into consideration a test of whether consumers would be 'worse off', rather than consider the impact of any proposed change in approach to the long-term interests of consumers in price, quality, reliability and security of supply (i.e. the NEO/NGO objectives that bind AER revenue determinations and AEMC rule decisions).

Maximisation of company taxation revenues is not a matter or objective that is specified in:

- relevant energy laws or energy rules guidance;
- AER's agreed statement of expectations or strategic priorities;
- the Minister's request for the AER to undertake the review.

This is appropriate given the role of the AER and the focus of this review, being whether the method for estimating the cost of corporate income tax in the regulatory framework remains appropriate.

Maximising the level of collected taxation payments may be a relevant objective for the Australian Taxation Office. ENA does not understand, however, how the AER as an

12 Department of Energy and Environment Submission, 23 November 2018, p.9
13 Department of Energy and Environment Submission, 23 November 2018, p.6

independent economic regulator can place any weight on policy objectives clearly laying outside its functions and powers.

Claim #10 – The ATO is ideally placed to advise on the complex matters and fill information gaps in the economic regulatory issues arising in the review[14]

The submission states that the ATO is ideally placed to fill in information gaps noted in the AER Discussion Paper as it relates to detailed tax information in relation to network entities.

It may be of value for AER to seek further information in this regard from the ATO. ENA notes that the ATO has recently indicated its in-principle willingness to assist and meet any relevant request. Confirmation that the ATO is able to provide timely and accurate informational support to the full scope of information would be welcome.

ENA would note that the ATO has not been able, as far as we know, to fill in information gaps in 2018, as part of the Rate of Return Guideline process. For the purpose of estimation the value of franking credit, ENA requested ATO provide to the guideline process reliable statistics on:

- Total corporate tax collected by the ATO from all Australian firms each year
- Total franking credits redeemed from the ATO each year

Provision of such data would appear to fall within the core functions and competencies of the ATO. Since ENA raised the utility of these information sets in June, and reiterated the request in September, it is unclear whether ATO has been able provide this essential economy-wide taxation data to fill in information gaps for the guideline review.

Rather, ATO has warned through the AER guideline process that:

> *Taxation Statistics data should not be used for detailed time series analysis of the imputation system*

The ATO has later expanded on its statement, adding that:

> *This applies to all aspects of the imputation system, not only the franking account balance line item. As previously advised, Taxation Statistics cannot be used to estimate the quantum of franking credits created, distributed or received by a company or group over time. This is because it has insufficient information to reliably quantify these amounts. Issues such as companies entering and exiting the tax system, churn within consolidated groups, uncollected debt and other complexities, such as the rules relating to life insurance companies, cannot be determined from the Taxation Statistics publication but would impact materially on any macro analysis of franking credits using Taxation Statistics aggregate data.*

ATO has also clarified that this caution to not rely on Australian Taxation Office published statistics in respect of this key regulatory estimation issue was due to the

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[14] Department of Energy and Environment Submission, 23 November 2018, p.2

fact that in their view elements of these statistics were subject to data reporting issues that were uncorrected in the production of the relevant statistics.[15]

ENA requests that early guidance be provided to stakeholders on the capacity of the ATO to meet both the information requirements of the regulatory tax review and of the ongoing Rate of Return guideline process. We are not aware of any reasonable reason why the ATO would be able to meet only one of these information requirements.

[15] ATO Memorandum, 14 September 2018